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True and Fair View- A Fact or Illusion in the World of Creative Accounting

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Abstract

Financial statements are major source of information and communication about company's prospects to all the stakeholders. While preparing financial statements, accountants are required to follow certain guidelines provided by Accounting Standards or International Financial Reporting Standards (IFRS) and Generally Accepted Accounting Principles (GAAP). A few loopholes in accounting standards provide enough room for Creative Accounting. Creative Accounting leads to window dressing and helps in projecting a very rosy picture of company's future prospects. In this study, possible situations where Creative Accounting is applied are described. The possible reasons for application of creative accounting might be to show more profits, to get good performance bonus, to pay less tax, to obtain loan from financial institutions, inflating share prices and many more. By applying Creative Accounting techniques, Financial Statements can be changed in such a way that, they will not present 'True and Fair view'. In today's world, Chartered Accountants are also called Creative Accountants. Partially this may be true, because a few of them may resort to creative accounting techniques to present the desired results in financial statements; which ordinarily would not be depicting the same picture otherwise.

Keywords: *Creative Accounting, True and Fair View, Fraud, Accounting Standards, Financial Reporting*

Introduction

Creative Accounting is a subject of vast and gigantic potentialities. If it is used judiciously and discreetly, it can admirably serve the purposes within the parameters of the specific objectives. Creative Accounting does not provide true and fair view of financial statements as a lot of crunching of financial numbers is done within the purview of applicable laws and prevailing accounting standards. (Amat, O., Blake, J., & Dowds, J. 1999) defined Creative Accounting as, "a process whereby accountants use their knowledge of accounting rules to manipulate the figures reported in the accounts of a business". According to (Gupta & Mohapatra 2009), "Creative Accounting is an accounting practice that follows accounting standards but slightly deviates from the spirit of those standards. The intention is to influence the interested parties towards the interpretations." (Jones, M. J. 2011) defined Creative Accounting as, "Using the flexibility in accounting within the regulatory framework to manage the measurement and presentation of accounts so that they give primacy to the interest of the preparers not the users". Jones, M. J. (2011) even pointed out that many other terms are used in connection with Creative Accounting like Aggressive Accounting, Earnings management, Impression management and Profit smoothing.

Most of the time, Creative Accounting is resorted to inflate profits, smoothening of financial results by manipulation, increase assets showcase and suppress liabilities.

By utilizing lacunae in prevailing regulations, Creative Accounting is resorted to manipulate the accounts and this cannot be held as fraud, as it is within the guidelines, Accounting Standards, International Financial Reporting Standards (IFRS) and Generally Accepted Accounting Principles (GAAP). To get benefits from top management, managers are tempted to show higher profits, which lead to adopting Creative Accounting tactics.

Creative Accounting is different from fraud.
Creative Aspect–within regulatory framework
Fraud Aspect–outside the regulatory framework

The new generation definition of Creative Accounting has changed from 'Chartered Accountant' to 'Creative Accountant'. Creative Accounting is a starting point of a number of accounting scandals. Enron, World Com, Satyam, Madhavpura Mercantile cooperative bank crisis and many more which collapsed during the last decade, applied Creative Accounting techniques and manipulated financial records. These accounting scandals have diminished the confidence of stakeholders in financial reporting the world over.

Literature Review

Some of the views about Creative Accounting are:
(Mahindra A.K., 1997) pointed out that if a company has to manipulate the earnings figure, the accounting standards set by professional bodies provide enough room to use Creative Accounting techniques. (Balasubramanian C.R., 1998) highlighted the vast area of opportunities, challenges and exposures that lie ahead in the exciting field of Creative Accounting. (Sukanya P., 2005) found out that the basic requirement that the companies must comply with is 'Generally Accepted Accounting Practice' (GAAP) to curb the practice of Creative Accounting. (Chakravarthi A. 2008) concluded that Creative Accounting is used not only by large companies but also by small companies for tax saving purposes. According to him, without financial reporting premised on sound, honest numbers, the capital market will collapse upon themselves. (Okoye, E. I. 2008) explored the nature and incidence of Creative Accounting practices in corporate financial reporting within the context of ethical considerations and the challenges faced by the regulatory authorities in Nigeria. The study concluded that there is a wide variety of motivations for managers to engage in Creative Accounting and that the ethical implication of Creative Accounting raises the need for a close scrutiny of the potential abuse of accounting policy choice and manipulation of transactions. (Ghosh S., 2009) pointed out that in spite of various guidelines provided by the Companies act, Dept of Companies affairs, Institute of Chartered Accountants of India and Securities and Exchange Board of India, there have been a number of accounting scandals in India since 1980's mainly due to Creative Accounting providing flexibility in accounting system. (Gupta & Mohapatra 2009) concluded that the auditor should not hesitate to find those areas where Creative Accounting is applied so that it can be prevented in the future. (Shah, S. Z. A., & Butt, S. 2011) concluded that the complex and diverse nature of the business transactions and the latitude available in the accounting standards and policies make it difficult to handle the issue of Creative Accounting. It is not that Creative Accounting solutions are always wrong. It is the intent and the magnitude of the disclosure which determines its true nature and justification. (Soral, G., & Kamra, A. 2013) in their study explored the ethical and unethical aspects of Creative Accounting with the help of case studies of selected companies. The study concluded that proper knowledge of ethics and information of analyzing financial statements may reduce unethical practices and it was suggested that proper check system should be developed and updated regularly for the people in the top position, who make a clear violation of the rights provided to them. (Kalra, Bhatia & Sachdeva., 2014) found that survival in the tough competitive environment and increasing pressure of performing well have become the main motivator of adopting Creative Accounting practices. They pointed out that regulation without thorough enforcement techniques is likely to be ineffective in preventing individuals from employing misleading reporting practices.

Need of the Study

In the present scenario, when the corporate sector around the world is already facing lot of accounting scams and scandals, adoption of unethical and illegal practices through Creative Accounting is leading to more frauds. Ethical behavior is most important for long term success. Strong corporate governance, along with quality accounting practices and transparent disclosures ensure that companies financial statements really represent a, 'True and Fair view'. With the help of sound financial reporting, honest numbers will help the capital markets from collapse like Harshad Mehta's scam, Ketan Parekh scam, Enron case , Satyam case etc. Hence, in this study, an attempt has been made to deliberate upon the various aspects of Creative Accounting like:

- Why Creative Accounting practices are adopted by companies?
- What are the possible situations where company managers apply 'Creative Accounting' techniques?
- Some suggestions and recommendations for preventing Creative Accounting practices, which can enhance quality of financial reporting, such that, the financial statements actually represent a 'True and Fair view'.

Why "Creative Accounting"?

Creative Accounting is employed by the end group to provoke and encourage better efforts to achieve higher objective. It also encourages staff towards higher productivity from a present situation. The shareholders and market reaction is judging the situation on the basis of prompt actions of managers and directors. Shareholders continuously follow the track record of the company's profit, growth and earnings per share and also look for availability of bonus in future from the company in which they had invested. So directors of the companies have pressure to present the report which provides the picture that the investors want, and, sometimes this needs Creative Accounting.

Creative Accounting is also resorted to manipulate earnings, to avoid showing a lower net worth (as this would affect borrowings from banks, financial institutions and depositors). Higher Earnings per share ensures a good market price and a company can avail the capital market for funds very easily. Investors prefer to invest in companies having stable profits than variable profits and hence companies try to project the same. In a monopoly, company is compelled to hide large profits and sometimes boosting of assets is required to avoid take-over. Ups and downs are the parts of life cycle of any industry or company. No company is interested to show a particular time as a bad year for the company; so they are forced to declare an exceptionally good year as normal year or even portray a bad year as a normal year by using Creative Accounting. Sometimes company is facing continuous pressure to be the best. Income boosting is one of the best options available to directors to protect company from any adverse news which can damage the image of the company in market. So, companies make various provisions for liabilities like provision for bad debts against assets like debtors, to show reduced profits in a profitable year. This will also help the company, if it is going to raise capital through fresh issue of shares. In some situations, a few managers/directors of companies may want to gain from their inside information and thus may want to use Creative Accounting to defer making any information available to the market.

Possible Situations Where Company Managers Apply 'Creative Accounting' Techniques

To show more profits, manager may show more purchases by creating fake purchase orders. By showing that extra goods (which is not the reality) in his books, he can show more sales and closing stock which are not existent. Another way adopted by organization may be, to suppress original purchase orders; not mentioning those purchases as a part of stock and sell without bills to customers. In India, in some cases, this type of practice prevails where people normally do not ask for a bill e.g. a Grocery shop and also in Medical stores, as many customers do not ask for a bill; only those people who have medical claim or if they have to submit bills to their organizations might prefer bills.

Management tends to maximize write-offs of obsolete inventory in profitable years but minimize such write-offs in non-profitable years. Management's estimate for the provisions required to cover disputed and other liabilities are also highly subjective. When company is doing well, management will provide more than what would be required. These extra provisions will reduce profits of that time period but in slack time, management can get back these `extras' for enhancement of profits. This process of accumulating extra provisions again begins in profitable years. Provision for gratuity is not tax deductible and therefore a few companies are not following this policy which depletes earnings but gives no immediate tax relief. By changing the timing of expenses and revenues, earnings manipulation is done, for example, companies may postpone repair expenditure to the subsequent accounting period to show higher profit. Companies can also ship goods for sale a little earlier or later, to adjust income in that particular year. Companies may speed up the issue of materials for consumption since the issues would get deducted from present revenue. Companies sometimes also approve those accounting policies which are not in agreement with the established accounting treatment, e.g.: Provision for disputed liabilities is not made, export settlement is done on receipt basis and bonus is accounted on repayment basis. Some companies capitalize future interest on loans taken to acquire fixed assets. ICAI has not recommended this type of practice. Some other situations where Creative Accounting is possible are: A company which is disclosing Contingent assets and liabilities and where the contingency aspect is debatable; A company against whom claims are pending and are neither accepted nor disputed; A company whose assets are installed into use but have developed major installation defects during test runs and such many more similar reasons.

Suggestions and Recommendations

If Creative Accounting is used to fulfill specific objective of internal management requirement; then, in this situation, it should be monitored very closely and the Creative Accounting technique used, should not be used in future again, after the definite objective has been achieved. In general, conditions should be strictly checked to examine and evaluate the situation warranting changes. If outcome of creative techniques have an effect on the disclosure of financial status of the company which might affect the decision of stakeholders, then it should be disclosed. In authentic financial reporting, some common attributes which need to be followed are - strong internal control, existence of proper audit committee as per mandatory requirements of clause 49 listing agreement: no family relationships among directors / officers; Board members having no controlling interest and have substantial experience of serving the companies. Obtaining professionals' services from different areas like technology and management, marketing, finance, etc., may help as the lack of expertise in these areas will end up. Options of various allowable accounting treatments available should be reduced or may be the situations in which each method can be used should be specified in detail.

Creative Accounting practices may be restricted by comparison with the last year's financial statements to detect fictitious revenues; examination of odd or abnormal journal entries and verifying the supporting sales or revenue entries with the relevant documents. Fraudulent timing differences can be eliminated by timely recognition of revenues and expenses; any material facts, which affects stakeholders but not covered in the financial statements, should be disclosed in footnotes.

Conclusion

Auditor is a watchdog and not a bloodhound is an old phrase. Now a day's auditors should behave like a blood hound and his thinking should be like: "when there is a hound, facts are found". Although the departure from accepted accounting policies is disclosed in financial statements, readers and users seldom have the relevant and complete information or expertise to understand adjusted figures indicated in the statements. It is the duty of an auditor to provide financial statements with 'True and Fair view'. For any violation of rule, auditor should be penalized. Creative Accounting is an intelligent exercise but as an auditor, he should ensure himself that the dishonest elements should not take advantage of a situation whereby there could be a benefit in the short term but in long run, it may end up in serious consequences for violating any of the existing laws. If the current accounting framework is restructured and strict adherence to corporate governance guidelines is ensured, then practices of Creative Accounting can be curbed. It is recommended that accounting rules and regulations should be strictly adopted by companies so that no one can get any advantage of the existing loopholes of accounting framework, otherwise strict legal action must be taken. This may ensure, 'True and fair view' of financial statements.

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